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IN THE

Supreme Court of the United States

STANFORD R. BROOKSHIRE and wife,
EDITH M. BROOKSHIRE, and
VORIS G. BROOKSHIRE and wife,
HELEN M. BROOKSHIRE,

Petitioners,

—VS—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

---

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

NO. . . .

STANFORD R. BROOKSHIRE and wife,
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Petitioners,

— VS —

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

The Petitioners respectfully pray that a Writ of Certiorari be issued to the United States Court of Appeals for the Fourth Circuit, to the end that this Court may review a judgment which the said Court of Appeals has rendered in the above-entitled cases.

OPINIONS OF THE COURTS BELOW

The opinion of the Court of Appeals was rendered on January 4, 1960, and is reported in 273 F. (2d) 638. It appears hereinafter as Appendix A.

The opinion rendered by the Tax Court of the United States is reported at 31 T.C., 1157. It is reproduced as Appendix B hereinafter.

Jurisdiction

The judgment of the Court of Appeals, which the Petitioners seek to have this Court review, was rendered on January 4, 1960 and was on that date entered upon the records of that Court. By order entered in this Court on March 28, 1960, the time for filing petition for Writ of Certiorari was extended to and including May 4, 1960.

Jurisdiction in this Court to review the judgment of the Court of Appeals, through the issuance of Writ of Certiorari, is established by the provisions of 28 U.S.C.A. Sec. 1254(1).

Questions Presented

This is a civil tax case arising under Sections 22(c), 41, 42 and 43 of the Internal Revenue Code of 1939, and the following questions are presented:

1. Where a merchant purchases goods for resale and at the close of his business year the goods are still on hand unsold, though saleable, may he properly deduct the cost of such goods from his taxable income for that year?

2. Where a merchant sells goods on open account and the sale price remains unpaid at the close of his business year, may he omit from his income for that year the sale price of such goods?

3. Are Sections 29.22(c), 29.41-2 and 29.41-3(1) of Treasury Regulations 111 valid and reasonable interpretations of Sections 22(c) and 41 of the Internal Revenue Code of

1939 and if so, what degree of flexibility may be permitted in their application?

4. Where a taxpayer who has been reporting his income for taxation under a method of accounting whereby erroneous deductions were taken and income improperly omitted, voluntarily changes his method of accounting for and reporting income to a proper one, may the errors of the prior year or years be corrected by increasing the income of the year of the change?

Statutes Involved

Internal Revenue Code of 1939:

Sec. 22. GROSS INCOME.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * *

(26 U.S.C. 1952 ed., Sec. 22)

Sec. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar

year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

(26 U.S.C. 1952 ed., Sec. 41)

Sec. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) [As amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687] *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * * (26 U.S.C. 1952 ed., Sec 42.)

Sec. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits * * * provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *
(26 U.S.C. 1952 ed., Sec. 43.)

Treasury Regulations Involved

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22(c)-1. Need of Inventories.—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. * * *

Sec. 29.41-2. Bases of Computation and Changes in Accounting Methods.—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchase and sales will correctly reflect income except an accrual method. * * *

The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under

the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change for cash receipts and disbursements method to the accrual method, or vice versa; * * * Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. * * *

Sec. 29.41-3. Methods of Accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting, as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. * * * Among the essentials are the following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, in-

ventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year * * *.

Statement of the Case

The Petitioners were members of a partnership, composed of themselves and their wives, known as Engineering Sales Company. The partnership originally operated as a manufacturers' agent, selling on a commission basis, taking no title to the merchandise and assuming no responsibility for the collection of accounts. The books were set up on a cash receipts and disbursements method of accounting.

Gradually the partnership began to buy and sell merchandise on its own account and to make sales on credit. It set up an accounts receivable ledger and a sales journal and began recording inventories of merchandise at the close of each year. By at least the year 1948 the purchase and sale of merchandise had become the major income-producing activity of the partnership. However, it continued to report for income tax purposes on the cash receipts and disbursements method of accounting until the year 1952. In that year it voluntarily changed to the accrual method of reporting but did not include in its income the accounts receivable outstanding on December 31, 1951, and collected in 1952, and it included in the cost of goods sold in 1952 the merchandise on hand on December 31, 1951, which it sold in 1952.

In accepting the 1952 return on the accrual basis, the Commissioner increased the 1952 income by (1) the amount of cash collected in 1952 on the accounts receivable outstanding on December 31, 1951; and (2) the net amount of the mer-

chandise inventory on December 31, 1951, which had been included by the partnership in its cost of goods sold in 1952. The Commissioner thus determined deficiencies against the Petitioners[2] for the year 1952 as follows: Stanford R. Brookshire, $28,109.88; Voris G. Brookshire, $27,785.56.[3] In the alternative the Commissioner accepted the return for the year 1952 as filed, but adjusted the returns for the years 1950 and 1951 to the accrual basis. In so doing, he included in the income for the year 1950 the amount of cash collected in 1950 on the accounts receivable outstanding on December 31, 1949, and did not include in the cost of goods sold in 1950 the merchandise inventory on hand at December 31, 1949. The Commissioner thus determined deficiencies against the Petitioners in the alternative as follows: Year—1950; Stanford R. Brookshire, $15,806.32, Voris G. Brookshire, $15,269.24;[4] Year—1951; Stanford R. Brookshire, $1,568.23, Voris G. Brookshire $1,499.12. Since the Commissioner's recomputation of income for the year 1951 did not include the collections on 1950 sales, and included in the cost of goods sold the inventory of December 31, 1950, the Petitioners paid the deficiencies determined for the year 1951.[5]

The determinations of the deficiencies by the Commissioner for the years 1950 and 1952 were appealed to the Tax Court of the United States on the ground that the errors made in

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[1] The "Net" amount of merchandise inventory is after adjustment for accounts payable.

[2] The Petitioners' wives are included in this action by reason of the filing of joint returns. Hereinafter only the male petitioners will be referred to.

[3] Appendix B, Page 2.

[4] Appendix B, Page 2.

[5] Appendix B, Page 7.

the years 1949 and 1951 whereby deductions were taken in each year for the purchase of merchandise which was still retained at the close of the year, and income from the sales of merchandise made during each year was omitted, could not be corrected by correspondingly increasing the income of the years 1950 and 1952. The Tax Court upheld the determinations for the year 1952 on the ground that the income was correctly reported on the cash basis in all years prior to 1952 and, therefore, the deduction taken in 1951 for the purchase of merchandise could not again be taken in 1952, while the cash collected in 1952 from 1951 sales must be included in 1952 income. The Court rejected the Commissioner's alternative claim for the year 1950 on the ground given for upholding that for the year 1952.[6]

Thereafter, the Petitioners filed with the Tax Court a motion for reconsideration of the opinion, which was denied.

Appeal was taken by the Petitioners under Section 7482 of the Internal Revenue Code of 1954 to the Court of Appeals for the Fourth Circuit which upheld the Tax Court on the same ground announced by the latter, and on the additional ground that the Petitioners had not requested the permission of the Commissioner to change to the accrual method.[7]

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[6] Appendix B. The Petitioners had also claimed that since the closing inventories and receivables of the year 1951 had already been taxed and the tax paid, the Commissioner could not again tax them for the year 1952. This position was foreclosed by the finding of the Court that the cash basis was proper for the year 1951.

[7] The Tax Court did not base its decision on this ground. It merely said, "It did not request the permission of the Respondent to such a change in method, but the Respondent accepted this method for 1952. The parties have stipulated that this was the proper method for that year". Appendix B, Page 8.

Reasons for Allowance of the Writ

This case involves a question which has been the subject of a considerable amount of litigation, but which has never been presented to this Court. The question embraces one of the fundamental concepts of income taxation, the computation of income on the basis of a fixed annual accounting period, and is concerned with what adjustments may or must be made when a taxpayer's method of accounting is changed in whole or in part from one form to another.

Until the time of the decision hereby sought to be reviewed, it appeared that the law on the question had been fairly well settled by a long line of decided cases[8] both in the Circuit Courts and the Tax Court. But the opinion of the Court of Appeals in this case[9] has injected a new factor into the question, which is not only in conflict with many of the previous decisions but which casts doubt upon the validity of the Treasury Regulations concerned. While the issues here involved arose under the Internal Revenue Code of 1939, the same questions are presented with respect to the Internal Revenue Code of 1954.[10]

The decision of the Court of Appeals for the Fourth Circuit is in error in the following respects:

(1) It is in conflict with the prior decisions of other Circuit Courts of Appeals.

(2) It fails to clarify a state of uncertainty as to the law,

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[8] Hereinafter cited and analyzed.

[9] Appendix A.

[10] Therefore, it is still a "live" issue.

which is indicated by a reading of some of the prior Court decisions.

(3) It casts doubt upon the validity of the Treasury Regulations involved.

(4) It leaves in doubt the proper interpretation of the Statute and Treasury Regulations under the Internal Revenue Code of 1954.

Summary of Argument

The decision of the Court of Appeals in this case is in conflict with a number of prior Court decisions. The Court attempts to avoid a conflict by finding that in all years prior to the taxable year in question the cash method of accounting clearly reflected the income of the partnership and, therefore, there were no errors in the computation of taxable income for those years. But this finding in itself creates a conflict with the other cases, where, in the same factual situation as here, it has been determined that the bookkeeping methods of the prior years had no bearing on the question. The case law up to the time of the instant decision, being grounded upon the proposition that the errors of one year cannot be corrected in a later one, established the principle that an erroneous deduction is taken when the cost of goods which remain on hand is charged against the income of the year in which they are bought. The principle was also established that where goods are bought and sold, the sales in each year must be matched against the items sold. The question of whether or not the cash method clearly reflected income is not susceptable of determination by opinion testimony but must be answered from the facts in the record as a whole.

Not only does the opinion conflict with earlier decisions, but the Court cites with approval certain cases where *obiter dicta* serve to confuse the issue. Furthermore, the announcement of a rule of "reasonable flexibility" in applying the Treasury Regulations, in the case at bar, can only serve to add confusion to a situation which is already the subject of considerable general misunderstanding. As this decision now stands, a serious question is posed as to amount of latitude to be permitted in interpreting the applicable Treasury Regulations or, in fact, whether they may be ignored altogether.

This uncertainty, both with respect to the state of the law and the application of the regulations, will have a continuing impact under the Internal Revenue Code of 1954.

Argument

I

The Decision is in Conflict with the Prior Decisions of other Circuit Courts of Appeals

(a) For purposes of background, the first case of importance on the issue here involved was *Hardy, Inc. v. Commissioner.*[11] There the Commissioner changed the taxpayer's method of accounting from cash to accrual but included in its income for the year of the change the untaxed accounts receivable at the beginning of the year and did not allow the beginning inventory as a part of the cost of goods sold. The books had been kept on the cash basis. The action of the Commissioner was sustained by the Second Circuit, but in *Commissioner v. Dwyer*[12] the same Court specifically overruled the *Hardy* case.

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[11] 82 Fed. 2d. 249.

[12] 203 Fed. 2d. 522.

(b) *Commissioner v. Mnookins' Estate.*[13]
Commissioner v. Frame.[14]
Commissioner v. Schuyler.[15]
Commissioner v. Cohn.[16]

These cases are grouped together since they all follow the same pattern. In each of the cases the taxpayer's books were kept on the accrual method of accounting but the returns were prepared either partially or wholly on the cash basis. *Mnookin, Frame* and *Cohn* involved the opening accounts receivable; while *Schuyler* involved opening inventory.

In each of the above cases the Court held that although the items in question had escaped taxation in the prior years, they could not be included in the income of the year of the change. In order to avoid a conflict with *Hardy, supra,* the opinions in these cases carefully pointed out that the books had been kept on the accrual method and, therefore, the income in question had accrued in the prior years.

These cases are also cited principally for purposes of the background of the litigation. There it was found that the books had been maintained on the proper basis but the returns had been prepared on an improper one. In the case at bar it was found that the cash method was correct in the prior years for both the books and the returns.

(c) *Welp v. United States.*[17]

Here, however, the litigation takes a different turn. The

[13] 184 Fed. 2d. 89.
[14] 195 Fed. 2d. 166.
[15] 196 Fed. 2d. 85.
[16] 196 Fed. 2nd. 1019.
[17] 201 Fed. 2d. 128.

taxpayer kept his books on the cash basis, but maintained a record of inventories (he did not sell on credit). His returns also were filed on the cash basis. The Commissioner recomputed the income for the year 1946 by deducting the closing inventory from the cost of the goods purchased and did not increase the cost by the inventory on hand at the beginning of the year. The Court of Appeals for the Eighth Circuit held that the opening inventory must be included in the cost of goods sold, for otherwise the error of a prior year would be treated as income of the year of the change. This case still stands as one of the leading cases on this point.

The Petitioners urge that a careful analysis of the opinion in this case must lead inevitably to the conclusion that the entire theory of the case at bar is in direct conflict with it.[18] There the Court held that methods of bookkeeping, or changes from one method of accounting to another, have nothing to do with the question,[19] but that the time of the accrual of income must be determined from the factual situation. It says:

> "There can be no doubt from the record that the opening 1946 inventory consisted of feed, produce and supplies theretofore purchased out of operating revenue, and the cost thereof deducted from gross profits. The result was that the valuation placed on this inventory represented past profits or income as surely as if the cash with which the inventory had been acquired had been retained in kind."

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[18] At least as far as inventories are concerned, accounts receivable were not involved.

[19] Citing *Northwestern States Portland Cement Co. v. Huston*, 126 Fed. 2d. 196, 199.

The opinion also quotes with approval a part of the memorandum opinion of the lower Court to the effect that the purchase of goods for inventory constitutes an "investment" in such goods.[20] This concept may be illustrated by the example of a taxpayer who buys a piece of real estate he expects to resell at a profit. The fact that he keeps his records and reports his income on the cash basis would not entitle him to deduct the cost of this real estate in the year in which he buys it if he still owns it at the end of the year.

The Petitioners respectfully submit that the case at bar cannot avoid a contradiction of *Welp* merely by finding that the cash method correctly reflected income. Such a finding is directly contrary to the theory of the *Welp* decision, *namely* that an erroneous deduction is taken when the cost of goods which are retained, is charged against income. Accounting methods have no place in this determination.

(d) *Caldwell v. Commissioner.*[21]

This case upholds the validity of the Treasury Regulations, Sec. 29.41-2, in requiring that sales must be reported on the accrual basis where inventories are required in computing income,[22] and explains why this is necessary in order to correctly reflect income.

More important, however, in assessing the element of conflict in the decisions is the Court's finding with respect to the bookkeeping methods employed. A careful reading of the

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[20] In *Commissioner v. Schuyler, supra*, the "investment" concept is also asserted.

[21] 202 Fed. 2d. 388.

[22] Citing *Herberger v. Commissioner*, 195 Fed. 2d. 293, Cert. den. 73 S. Ct. 17.

opinion, together with the Tax Court report,[23] discloses that the records kept by *Caldwell* were very similar to those used by Engineering Sales Company as disclosed by the record in the instant case. Yet the Court did not find that the books were kept on the cash basis but said:

> "In any case, however, the Commissioner was able to obtain all the figures necessary for his recomputation of the taxpayer's income from the books and records as they had been kept ever since the business was founded. A change to the accrual method of reporting income thus required no change in his bookkeeping method."[24]

The opinion in the case at bar, therefore, conflicts with *Caldwell* in two respects; (1) it does not uphold the Treasury Regulations requiring accrual reporting, and (2) it bases the decision upon the fact that the books were kept on the cash basis whereas in *Caldwell*, with the same factual situation, it was determined that the accrual basis was being used.

(e) *Commissioner v. Dwyer.*[25]

This decision specifically overruled *Hardy, Inc. v. Commissioner, supra.*

Here, again, is the case of a taxpayer engaged in the business of buying and selling merchandise but keeping his books and

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[23] T. C. Memorandum Decision 6/29/51, Dkt. No. 28086.

[24] In the case at bar the Commissioner, in the determination of his alternative position, was able to recompute the partnership income on the accrual basis for the years 1950 and 1951 from the books and records maintained by the taxpayer.

[25] 203 Fed. 2nd. 128.

reporting his income on the cash method. The Tax Court[26] sustained the Commissioner in requiring the income to be reported on the accrual basis on the authority of the Treasury Regulations, which it did not question in any way, but did not permit him to reduce the cost of goods sold by the opening inventory. The Tax Court further held that since a record of the inventories was "available", the taxpayer's books clearly reflected his income.

In sustaining the Tax Court, Judge Hand makes an exhaustive analysis of the inventory question and says:

> "The cost of an article is never, as such, a deductible expense of the business; • • • • • • Obviously the equation cannot be computed until the article is sold, and it follows that until then its cost ought to be carried in suspense."

This is another way of stating what was said in *Welp v. United States, supra* and *Commissioner v. Schuyler, supra.*

Here, again, is a conflict in the decisions. The question of whether or not the accounting method used in prior years clearly reflected income is not even considered. The decision is grounded squarely on the concept announced in *Welp* and *Schuyler*, that an error is committed when a deduction is taken for the purchase of goods which remain on hand at the close of the taxable year.

(f) *Goodrich v. Commissioner.*[27]

The Court of Appeals has attempted to distinguish the prior

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[26] *Cornelius J. Dwyer v. Commissioner*, T. C. Memorandum Decision, 6/29/51 Docket No. 27472.

[27] 243 Fed. 2nd. 691.

decisions partly on the ground that in the instant case the taxpayer *voluntarily* changed its method of bookkeeping and reporting whereas in the earlier cases the change was always initiated by the Commissioner. Leaving the question of the taxpayers' motive for the change to argument on the merits, the Petitioners assert that the opinion is in conflict with the *Goodrich* case on this point. There the taxpayer kept his books and reported his income on the accrual basis except that sales were recorded and reported on the cash basis. He changed his method of reporting sales to the accrual basis without requesting the consent of the Commissioner, who accepted such method but sought to include the opening accounts receivable in the income of the year of the change.

In substantiation of his authority to do this the Commissioner cited the provisions of Treasury Regulations Sections 29.41-2[28] to the effect that a taxpayer must request the permission of the Commissioner to make a change in his accounting method and that such permission will not be granted unless "the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected." In denying the Commissioner the right to impose this condition the Court said:

> "* * * it is to be emphasized that there is nothing in the language of the regulation to suggest that, if a taxpayer fails to comply with the requirement for first obtaining permission from the Commissioner, he will as a penalty or as a consequence be deemed to have agreed by legal implication to whatever terms or conditions the Commissioner may see fit to impose."

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[28] Page 6, *supra*.

In spite of the above, the Court of Appeals in the case at bar supports the adjustments made by the Commissioner, at least in part, on the basis of the regulation cited. This has the effect of denying to the taxpayers their right to contest the propriety of adjustments made, through the statutory processes of appeal.

II.

The Decision Fails to Clarify a State of Uncertainty as to the Law, Which is Indicated by a Reading of Some of the Prior Court Decisions

The Court of Appeals says that it would be idle to attempt to reconcile all of the cases.[29] The Petitioners respectfully urge that there is no conflict in the cases prior to the instant one. However, the wording in some of the previous opinions may suggest a conflict if the facts in each case are not carefully analyzed. The opinion of the Court of Appeals in the case at bar, rather than clarifying this uncertainty, tends to further confuse the issue.

This objection is predicated on the fact that the opinions in some of the decided cases, by way of *obiter dicta* or otherwise, create doubt as to the impact of some of the prior decisions. Aside from some cases which were decided prior to the overruling of the *Hardy* case, *supra*, where the method of accounting was distinguished to avoid conflict,[30] the opinions of the Circuit Courts contain no material qualifications except for that found in *Commissioner v. Goodrich, supra.* There the Court, in reply to the Respondent's objection that if the adjustment attempted by him cannot be made, the accounts receiva-

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[29] Appendix A, Page 9.

[30] e.g. *Mnookins Estate, Frame, Schuyler, Cohn, supra.*

ble accumulated at the beginning of the year escape taxation, the Court stated that the "accounts involved had had an income status created for them on a cash realization basis, under the accounting method which the taxpayer had employed as to them." This finding was not a basis for the decision,[31] but appears contrary to the prior decisions hereinbefore cited. However, it should be noted, (1) that case involved accounts receivable only, and (2) the decision was confined to the facts of the particular case, the report of which does not contain any specific information as to the method of doing business. These distinctions should be emphasized, but the Court of Appeals in the instant case fails to supply an clarification in quoting the above from the opinion in *Advance Truck Company v. Commissioner.*[32]

At this point the Petitioners should like to call the attention of this Court to a phase of the subject here in controversy which appears to occasion confusion. That is the distinction required between inventories and accounts receivable. There has never been any provision in the Treasury Regulations which, of itself, requires a taxpayer who extends credit to report his income on the accrual basis. Service-type businesses, professional men and a great variety of non-merchandising enterprises are permitted to report income only as collected. It is only in the case of a merchandising business that the regulations require the matching of sales against items sold in order clearly to reflect income. This being so, the income of a business which sells no merchandise and records and reports its income on the cash basis realizes no income until

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[31] See page 291 and paragraph beginning "But even if the situation • • •"

[32] 262 Fed. 2d. 388.

collection is made,[33] and if such a business wishes to change to the accrual method of reporting it is entirely proper that it be required to seek the permission of the Commissioner to make the change and be required to report as income the outstanding charges as they are collected.

As to inventories, however, the concept is quite different. First, there can be no inventories within the meaning of the statute and regulations unless the business buys and sells merchandise. But the important point is that the previous cases are unanimous in holding that when a merchant deducts from his income in a given year the cost of an article which he retains at the close of the year, regardless of his accounting method, he has taken an erroneous tax deduction which can be corrected only in that year.

The Petitioners respectfully submit that if these distinctions were judicially explained, a considerable amount of confusion as to the status of the law on this question might be dispelled.

Some *dicta* in the case of *Clement A. Bauman*[34] also creates some uncertainty. Although holding for the taxpayer, the Court says:

> "It should be remembered that this is not a case where the taxpayers have been keeping their books and records on the cash basis and have sought to change over to an accrual basis without securing the consent of the Commissioner to make such a change. If it were that kind of a

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[33] As in *Advance Truck Co., supra.*

[34] 22 T. C. 7.

case, the situation might be different."[35]

The Court of Appeals here cites this case without comment although, as hereinbefore pointed out, the previous Circuit Court decisions have held that where the purchase and sale of merchandise is an income-producing factor, the prior book-keeping method is immaterial.[36]

III.

The Opinion Casts Doubt on the Treasury Regulations Involved

The state of uncertainty engendered by the opinion of the Court of Appeals is amplified by the pronouncement of a doctrine of "reasonable flexibility" with respect to the application of the Treasury Regulations.[37] While the Petitioners readily concede that almost any rule or regulation may be accorded some degree of flexibility, they maintain that the degree accorded them in this case is such as to render them almost meaningless.

The sections of the Treasury Regulations here involved unequivocally require that in order to reflect income correctly in *every* case in which the *purchase and sale of merchandise* is an income-producing factor, inventories of the merchandise on hand must be used in the computation of income, and the purchases and sales must be reflected on the accrual basis of

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[35] A comparison of the reports of the two cases shows that the book-keeping records kept by *Bauman* and Engineering Sales Company were almost identical.

[36] e.g. *Welp v. Commissioner, supra.*

[37] Appendix A, Page 9.

accounting.[38] The Court of Appeals, however, seems disinclined to accord these regulations much weight.[39] It speaks of "some reasonable flexibility" but gives no clue as to the possible limits of this tolerance. In the year 1951, the merchandise sales of the partnership reached $408,256.00; its closing inventory for that year was $62,679.00; its gross profit from sales was $85,594.00. At what point do the sales and the income produced therefrom violate this "flexibility" rule? And the uncertainties are multiplied when we note that for the year 1952 the sales were only $383,753.00; and the closing inventory was $66,411.00,[40] yet it is determined that not until 1952 must the requirements of the regulations be respected.

The Petitioners submit that the sales, inventories and accounts receivable of this partnership, from at least the year 1948, were quite substantial in comparison with the average merchandising business in the nation. It is inconceivable that the regulations are intended to apply only to very large businesses. Thus the "reasonable flexibility" rule announced by the Court of Appeals creates a serious uncertainty, for taxpayers and Internal Revenue officials alike, as to the applicability of the regulations.

In *Goodrich v. Commissioner, supra,* the Court speaks of "a measure of discretion and flexibility" as essential

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[38] Sections 29.22 (c)-1, 29.41-2, 29.41-3(1).

[39] Appendix A. It says after quoting in part from T.R. 111, Sec. 21.21-2, "However, as the Tax Court noted, some reasonable flexibility must be permitted in determining when the purchase and sale of merchandise becomes such an income-producing factor as to require the use of inventories and a change to an accrual method, in order to reflect clearly the income of the taxpayer."

[40] Only $3,732.00 greater than at January 1, 1952.

in practical tax administration. This observation is made in connection with the question of whether or not the complete accrual basis was required in Goodrich's situation, and indicates the basis for the theory of "an income status on a cash realization basis" for the accounts receivable. (See discussion of *Goodrich, supra.*)

The recorded facts of the instant case render the findings of the Court of Appeals a complete distortion of the applicable Treasury Regulations. In this connection reference is made to a release by the Tax Research Institute, Inc. under date of February 13, 1960, which points up the confusion created by this decision.[41]

IV.

The Decision Leaves in Doubt the Proper Interpretation of the Statute and Treasury Regulations Under the Internal Revenue Code of 1954

In support of its position that the Commissioner is entitled to make such changes as he sees fit in computing the taxpayer's income in the year of change when the change is made voluntarily by the taxpayer, the Court of Appeals cites a congressional committee report which proposed the changes made by the 1954 Code.[42] This obviously relates to an excerpt from the report quoted in the Respondent's brief as follows:

> "Under present law *these adjustments are made whenever the taxpayer requests permission to change his method of accounting.* Where the Commissioner forces a

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[41] Appendix C.

[42] H. Rep. No. 1337, 83d. Cong. 2d. Sess. (3 U.S.C. Cong. & Adm. News (1954, 4017 at 4303).

taxpayer to change his method of accounting because the old method does not clearly reflect income, various Court decisions have denied the Commissioner the right to make the various adjustments". (Emphasis supplied)

The Petitioners take issue with the italicized portion of the above statement. It presupposes that under the 1939 Code the taxpayer must docilly accede to any adjustments which the Commissioner may wish to make. Let us suppose, for example, that a taxpayer, finding his accounting method is wrong according to the regulations, requests the permission of the Commissioner to change. The Commissioner grants the request on the condition that certain adjustments be made. The taxpayer takes issue with the required adjustments and files his return on the changed basis without making them. The Commissioner determines a deficiency by making the adjustments he had originally required. Were the taxpayers rights of appeal under the 1939 Code automatically forfeited because he took issue with this administrative determination?

The only material change made by the 1954 Code in this respect appears in Sec. 481(a)(2).[43] The wording of this

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[43] (a) GENERAL RULE — In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—

(1) If such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent accounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

section immediately poses two questions; (1) what adjustments may or may not be considered to be necessary in order to prevent amounts from being duplicated or omitted, and (2) is a change *"initiated"* by the taxpayer when it is made or requested because the Treasury Regulations state that the method he is using is wrong?[44]

The Petitioners believe that unless the case law is clarified the issues here involved will be the subject of continued litigation.

Summary

The decision in this case, if allowed to stand, only compounds a state of uncertainty which has existed through many years of litigation involving a large number of cases. Whereas, it appeared that the law in the matter was fairly well settled, we now find a new factor, the "reasonable flexibility" rule inserted, a factor which can only throw the entire question into a state of confusion. In view of the conflict with other decisions, the conflict with generally accepted principles of sound accounting and the doubt cast on the validity of the Treasury Regulations, the Petitioners respectfully submit that this Court should resolve the uncertainties which this decision creates.

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[44] As yet, no regulations have been issued on this section.

Conclusion

For the reasons and upon the grounds herein set forth, the Petitioners pray that a Writ of Certiorari be granted.

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UNITED STATES COURT OF APPEALS

FOR THE FOURTH CIRCUIT

No. 7977

STANFORD R. BROOKSHIRE and wife, EDITH M. BROOKSHIRE, and VORIS G. BROOKSHIRE and wife, HELEN M. BROOKSHIRE,

Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION TO REVIEW THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

(Argued November 13, 1959. Decided January 4, 1960.)

Before SOBELOFF, Chief Judge, SOPER, Circuit Judge and THOMSEN, District Judge.

Elton B. Taylor and F. T. Miller, Jr., (F. A. McCleneghan on brief) for Petitioners, and Victor A. Altman, Attorney, Department of Justice, (Charles K. Rice, Assistant Attorney General; Lee A. Jackson and Harry Baum, Attorneys, Department of Justice, on brief) for Respondent.

THOMSEN, District Judge:

Petitioners Stanford R. Brookshire and Voris G. Brookshire are partners trading as Engineering Sales Company. The other petitioners are their wives. In 1952 the partnership voluntarily, without seeking or obtaining permission from the Commissioner of Internal Revenue, changed its method of keeping its books of account and its method of reporting its income for federal income tax purposes from the cash receipts and disbursements method of accounting to the accrual method. The Tax Court sustained the action of the Commissioner requiring the partnership (1) to include in its 1952 income the monies collected in 1952 on accounts receivable existing as of 1 January 1952, representing sales made but not paid for in 1951, and (2) to reduce the cost of goods sold by that part of the inventory on hand 1 January 1952 which had been paid for and deducted from the partnership's income in prior years. The petition for review challenges those rulings.

The sections of the I.R.C. of 1939 and the T.R. 111 which bear upon the problem are set out in Note 1. The facts are set out in the careful opinion of the Tax Court, Atkins, J., 31 T.C. 1157, and may be summarized here.

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[1] Internal Revenue Code of 1939:

Sec. 22. GROSS INCOME.

* * * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

• • • • •

(26 U.S.C. 1952 ed., Sec. 22)

Sec. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. • • •

(26 U.S.C. 1952 ed., Sec. 41)

Sec. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) [As amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687] *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. • • •

(26 U.S.C. 1952 ed., Sec. 42.)

Sec. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits • • • provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. • • •

(26 U.S.C. 1952 ed., Sec. 43.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22(c)-1. Need of Inventories.—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. • • •

Sec. 29.41-2. Bases of Computation and Changes in Accounting Methods.—Approval standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income

unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchase and sales will correctly reflect income except an accrual method. • • •

The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change for cash receipts and disbursements method to the accrual method, or vice versa; • • • Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. • • •

The partnership originally operated as a manufacturer's agent, selling on a commission basis, taking no title to the merchandise, and assuming no responsibility for the collection of accounts. The books were set up on a cash receipts and disbursement method of accounting. Monthly and annual profit and loss statements were prepared on that basis. The partnership income tax returns for all years before 1952 were prepared on the cash basis; the figures used in computing income were taken solely from the cash receipts journal and the cash disbursements journal.

About 1940 the partnership began to make credit sales, and opened a cash receivable ledger for collection purposes. It also maintained a sales journal, in which invoices were listed by number and notations were made as to dates of payments. The entries in this journal were never totaled; they were used for cross-reference purposes only. For some years the inventory consisted solely of V-belts and material left over from such belts. About 1943 the partnership began to take a physical inventory at the end of each year and to prepare, for managerial information and occasionally for bank

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Sec. 29.41-3. Methods of Accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting, as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. • • • Among the essentials are the following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year • • •.

and credit reports, a balance sheet showing accounts receivable, accounts payable, and inventory. About 1945 the partnership began to make purchases for inventory, but before 1952 it maintained no accounts payable ledger. Neither the accounts receivable ledger, the sales journal nor the inventories were used in computing or reporting income.

The records and returns for 1948 and prior years were examined by an agent of the Internal Revenue Service sometime after 1948. Stanford Brookshire testified that this agent said it would be a good idea for the partnership to go on an accrual basis; the agent did not say that an accrual basis was required, and the returns were accepted on the cash basis. The method was not changed at that time, because the partners did not think it was necessary.[2] The Tax Court found that the cash receipts and disbursements method of accounting clearly reflected the income of the partnership for the years before 1952.

In 1952 a general ledger was set up. Accounts receivable, accounts payable and inventory existing as of 1 January 1952 were entered in this ledger with proper offsetting credits to the partners' capital accounts. The partnership did not request or receive permission from the Commissioner to change its method of accounting and reporting income,[3] but the partnership return for 1952 was prepared and submitted on an accrual basis. In that return the partnership did not include in income the amount of accounts receivable existing as of 1 January 1952, or the collections thereon during that

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[2] The change was made as of 1 January 1952, when the amount of inventory on hand had greatly increased and it was advantageous to petitioners to make the change, provided they were not required to make the adjustments at issue in this case.

[3] As required by T.R. 111, Sec. 29.41-2.

year; in computing the cost of goods sold, credit was taken for the full amount of inventory on hand 1 January 1952, including items which had been paid for and deducted prior to 1952.

The Commissioner accepted the 1952 return on the accrual basis, but increased the partnership's 1952 income (1) by the amount of the cash collected in 1952 on the accounts receivable representing 1951 sales and (2) by the net amount of the merchandise inventory which had been deducted from income both in 1951 and in 1952[4] This determination was

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[4] In explanation of the adjustments made for 1952, the Commissioner stated: "• • • By reason of the change cash in the amount of $32,402.54 collected in 1952 from sales made in 1951 was not included in sales reported in the partnership returns for either year. In order to correctly reflect income it is determined that this amount must be added to taxable income for the year 1952 as a necessary adjustment incident to the partnership's change in its method of accounting. • • • By reason of the change, the merchandise inventory valued at $62,679.22 on January 1, 1952, was deducted from income in the partnership's return for both of the years 1951 and 1952. In order to correctly reflect income it is determined that partnership is not entitled to the deduction in 1952 of the amount of the previously deducted inventory. As an offsetting adjustment to cost of goods sold it is determined, for the same reason, that the partnership is entitled to deduct the cost; $10,473.26, of merchandise purchased in 1951 but not paid for until 1952, and which was not deducted in its returns for either year. Accordingly, the cost of goods sold as reported in the 1952 return has been disallowed to the extent of the net amount of these adjustments, or $52,205.56."

In the alternative, the 90-day letters determined that the partnership income for the years 1950 and 1951 should be adjusted to the accrual basis, plus adjustments for the year 1950 for inventories and accrued accounts receivable (less accounts payable) representing income not previously taxed.

approved by the Tax Court.[5]

Taxpayers' contention seems to be: that in the years before 1952 the partnership was engaged in the purchase and sale of merchandise to a substantial degree, sold on open account, and had substantial inventories of merchandise and accounts receivable; that under T.R. 111, sec. 29.41-2, the cash method of accounting did not correctly reflect the net income for those years, so, despite the fact that during all of those years it kept its books on the cash basis and deliberately filed its tax returns on the cash basis, its action in so doing was erroneous, and the Commissioner had no right, in the year of change, to increase the income by items which taxpayers contend were properly income of a prior year or years.

Section 41 of the 1939 Code provided that net income should be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer; but "if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income".

During all years before 1952, the books of the partnership were kept on a cash basis. Taxpayers prepared their income tax returns on that basis and they were accepted by the Commissioner, who did not and does not question the adequacy of that basis for the years prior to 1952. T.R. 111, sec. 29.41-2

[5] The individuals paid the 1951 deficiencies. The petitions filed with the Tax Court related only to the years 1950 and 1952. Since the Tax Court upheld the Commissioner's determination of deficiencies in tax as to the year 1952, it held there was no deficiency for the year 1950, as determined by the Commissioner in the alternative.

states in part that "in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method". However, as the Tax Court noted, some reasonable flexibility must be permitted in determining when the purchase and sale of merchandise becomes such an income producing factor as to require the use of inventories and a change to an accrual method, in order to reflect clearly the income of a taxpayer. In some instances either method may clearly reflect the income.

The Tax Court found that the cash method clearly reflected the income of the partnership for the years before 1952. That finding was supported by opinion evidence and by other facts in the record; we cannot say that it was wrong.

Petitioners are not in the position of taxpayers who reported their income *incorrectly* in the past. On the contrary, they are taxpayers who, having kept their books and reported their income *correctly* on the cash basis, *voluntarily* changed their accounting method. Consequently, T.R. 111, sec. 29.41-2 required that they obtain the Commissioner's consent to the change in method and provided that the Commissioner's consent might be conditioned upon adjustments designed to prevent items being "duplicated or entirely omitted as a result of the proposed change". Actually petitioners did not apply for or receive the Commissioner's consent, but their failure to do so did not increase their rights or lessen their obligations. The adjustments required by the Commissioner were designed to prevent items from being duplicated or entirely omitted as a result of the change, and were justified by the facts.

It would be idle to attempt to reconcile all of the cases, but the decisions relied on by petitioners are distinguishable

on one or both of two grounds. Some, e.g. *Welp v. United States*, 8 Cir., 201 F. 2d 128, are distinguishable because the changeover was not made *voluntarily* by the taxpayer, but was *required* by the Commissioner. This distinction was emphasized by H. Rep. No. 1337, 83d Cong. 2d Sess., 3 U.S.C. Cong. & Adm. News (1954), 4017, at 4303, which proposed the changes made by the 1954 Code. See also *Clement A. Bauman*, 22 T.C. 7, at 12.

Other decisions, e.g. *Commissioner v. Dwyer*, 2 Cir., 203 F. 2d 522, are distinguishable because, in those cases, the taxpayer had *mistakenly* failed to report income (or had mistakenly taken a deduction) in a year prior to the taxable year, because the taxpayer had failed to employ or apply a correct method of accounting in such prior year. This distinction was noted in *Advance Truck Co. v. Commissioner*, 9 Cir., 262 F. 2d 388, 391.

In *Advance Truck*, as in the instant case, the taxpayer had properly used the cash method of accounting prior to the taxable year, and accordingly had not reported certain items which were not reportable under that method. The court said: "The accounts receivable of $20,431.48 had, as stated in *Goodrich v. Commissioner, supra* [243 F. 2d 691], 'an income status created for them on a cash-realization basis,' under the cash receipts and disbursements method which the petitioner had employed as to them. We are unable to agree with the petitioner that such status was changed simply because the petitioner changed its method of keeping its books of account to the accrual method for the year 1950." 262 F. 2d at 391. In the instant case the Commissioner properly determined that the accounts receivable on the books 1 January 1952 should be considered income as and when they were collected.

The adjustments required by the Commissioner were made to prevent duplications or omissions resulting from the voluntary changeover. They were not made to correct errors of past years. The Tax Court did not err in approving the determination of the Commissioner.

Affirmed.

APPENDIX B

31 T. C. No. 119

TAX COURT OF THE UNITED STATES

STANFORD R. BROOKSHIRE and EDITH M. BROOKSHIRE, Petitioners, *v.*

COMMISSIONER OF INTERNAL REVENUE, Respondent.

VORIS G. BROOKSHIRE and HELEN M. BROOKSHIRE, Petitioners, *v.*

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket Nos. 57277, 57278. Filed March 18, 1959.

A partnership of which the petitioners were members kept its books and filed its income tax returns on the cash receipts and disbursements method of accounting for all years prior to 1952. In 1952 it changed its method of accounting to an accrual method and filed its return for that year accordingly. *Held*, that the respondent properly adjusted reported income of the partnership for the year 1952 by increasing income by amounts collected in that year on accounts receivable as of the beginning of the year representing sales made in the prior year, and by reducing the cost of goods sold by that portion of the cost of inventory on hand at the beginning of 1952 which had been paid and deducted in the prior year.

F. T. Miller, Jr., Esq., Elton B. Taylor, Esq., and F. A. McCleneghan, Esq., for the petitioners.

Richard C. Forman, Esq., for the respondent.

ATKINS, *Judge*: The respondent determined deficiencies in income tax against the petitioners as follows:

Petitioner	*Docket No.*	*Year*	*Income Tax*
Stanford R. and Edith	57277	1950	$15,806.32
M. Brookshire	57277	1952	28,109.88
Voris G. and Helen M.	57278	1950	15,269.24
Brookshire	57278	1952	27,785.56

The principal question is whether in 1952, the year in which a partnership changed from a cash to an accrual method of accounting and reporting income it is required to include in taxable income the accounts receivable as of the beginning of that year which were collected in that year, and to reduce the cost of goods sold by that portion of inventory on hand at the beginning of 1952 which had been paid for and deducted prior to 1952.

The year 1950 is before us as a result of an alternative determination of the respondent for that year involving similar adjustments.

FINDINGS OF FACT.

Some of the facts are stipulated and the stipulation is incorporated herein by this reference.

The petitioners, Stanford R. Brookshire and Edith M. Brookshire, are husband and wife, residing near Charlotte, North Carolina. The petitioners, Voris G. Brookshire and Helen M. Brookshire, are husband and wife, residing near Charlotte, North Carolina. Stanford Brookshire and Voris Brookshire are brothers. For the years 1950 and 1952 both couples filed joint income tax returns with the collector of internal revenue

at Greensboro, North Carolina.

Engineering Sales Company, hereinafter referred to as the partnership, is a partnership composed of the petitioners, which was organized in 1932. The partnership filed income tax returns for the calendar years 1950 and 1952 with the collector of internal revenue at Greensboro, North Carolina.

The partnership originally operated as a manufacturers' agent, selling mechanical equipment to manufacturing plants on a commission basis, the partnership taking no title to the merchandise, assuming no responsibility for collection of the accounts, and being reimbursed purely on a commission basis.

The books of the partnership were originally set up on a cash receipts and disbursements method of accounting. A cash receipts journal and a cash disbursements journal were maintained with columns for various income and expenses. Monthly profit and loss statements were prepared by bookkeepers based upon the cash receipts and the disbursements. Annual profit and loss statements were prepared on the same basis. The partnership income tax returns for all years prior to 1952 were prepared on the cash basis, and the figures used in computing income were taken solely from the cash receipts pournal and the cash disbursements journal. The partnership returns of income and the partnership books were examined by field agents of the Internal Revenue Service for 1948 and certain prior years, and the partnership's practice of accounting and reporting income on the cash method was accepted.

About 1940 an accounts receivable ledger was established as the partnership began to make credit sales on its own responsibility, in addition to earning commissions as an agent. This ledger was kept principally for collection purposes. The partnership recorded therein sales and collections on sales. It

also maintained a sales journal in which invoices were listed by number and notations made as to dates of payments on the invoices. The entries in this journal were never totaled. They were used for cross-reference purposes only.

Until about 1943 the partnership's inventory consisted solely of "V-belts," at which time it began to have material from belts left over which was put into inventory. About 1943 the partnership adopted the practice of taking a physical inventory at the end of each year and preparing, for managerial information and occasionally for bank and credit reports purposes, a balance sheet with amounts shown thereon for accounts receivable, accounts payable, and inventory. About 1945 the partnership began to make certain purchases for inventory. Prior to April 1951, inventory records were kept on inventory sheets. Thereafter a card system of perpetual inventory records was kept.

Prior to 1952 the accounts receivable ledger, the sales journal, and the inventories were not used in computing or reporting income under the cash method employed by the partnership. Prior to 1952 the partnership maintained no accounts payable ledger.

The usual type of accounts receivable carried by the partnership was "2% cash, net 30." During the years in issue the partnership had no bad debts with respect to its accounts receivable and there was no instance of a customer taking as much as a year to pay his account.

In the year 1952 a general ledger was set up. Accounts receivable, accounts payable and inventory existing at January 1, 1952 were set up in this ledger with proper offsetting credits to the partners' capital accounts. When the time came

for filing the partnership return for 1952, that return was prepared and submitted on an accrual method of accounting. In such return the partnership did not include in income the amount of the accounts receivable existing as of the beginning of 1952 or the collections thereon during the year. Therein, in the computation of cost of goods sold, it included in opening inventory the full amount of inventory existing at the beginning of the year, including that which had been paid for and deducted prior to 1952.

At no time did the partnership request or receive specific permission from the Commissioner of Internal Revenue to change its method of accounting and reporting income from the cash to an accrual method, as prescribed by the Internal Revenue Code of 1939 and applicable regulations.

The following tabulation shows the amounts of inventory, accounts receivable, commissions earned and receivable, and value of partnership assets as of January 1 of each of the years 1945 to 1952, as shown by financial statements:

Jan. 1	Inventory	Accounts Receivable	Commissions Earned and Receivable	Gross Assets
1945	$ 8,890.24	$ 8,878.99	$19,228.93	$ 52,530.43
1946	8,263.14	17,159.40	57,081.83	92,216.78
1947	11,375.25	16,501.43	80,779.18	124,475.21
1948	12,710.00	26,918.50	65,082.42	120,813.75
1949	41,120.60	39,798.25	34,256.64	141,328.35
1950	35,272.07	7,677.30	9,795.33	89,412.32
1951	39,725.93	48,876.94	45,529.16	148,280.89
1952	62,679.22	32,402.54	34,968.36	147,485.75

The partnership returns show two main sources of income, namely, commissions and sales of merchandise. The

amount of gross sales, gross profit from sales, the amount of commissions, and the net income for each of the years 1948 to 1951, inclusive, as shown therein were as follows:

Year	Gross Sales	Gross Profit from Sales	Amount of Commissions	Net Income
1948	$356,636.10	$62,262.49	$67,032.90	$68,085.90
1949	281,774.23	91,920.60	39,069.01	78,873.27
1950	314,374.44	53,458.25	28,799.54	25,747.35
1951	408,256.73	85,594.20	39,865.37	67,487.11

At least by 1952 the partnership's nature of business had so altered and changed from its previous operations that the cash basis of accounting could not adequately reflect its income. At least by 1952 the purchase and sale of inventorial merchandise had become a major income-producing factor of the partnership.

In the notice of deficiency addressed to each of the petitioners, the respondent determined deficiencies for each of the years 1950, 1951 and 1952 with the following explanation:

> In the partnership return of Engineering Sales Company for the year 1952, the method of reporting income was changed from the cash to the accrual basis. It is held that since 1952 is the year of change the income for this year should be adjusted for the opening inventory and accounts receivable less accounts payable in the net amount of $84,608.50, which represents income not taxed in prior years.
>
> In the alternative, it is held that partnership income for the years 1950 and 1951 should be adjusted to the accrual basis, plus adjustment for the year 1950 for in-

ventories and accrued accounts in the net amount of $41,126.72 at January 1, 1950, representing income not previously taxed.

In explanation of the adjustments made for 1952, the respondent stated:

> * * * By reason of the change cash in the amount of $32,402.54 collected in 1952 from sales made in 1951 was not included in sales reported in the partnership returns for either year. In order to correctly reflect income it is determined that this amount must be added to taxable income for the year 1952 as a necessary adjustment incident to the partnership's change in its method of accounting.
>
> * * * By reason of the change, the merchandise inventory valued at $62,679.22 on January 1, 1952, was deducted from income in the partnership's returns for both of the years 1951 and 1952. In order to correctly reflect income it is determined that partnership is not entitled to the deduction in 1952 of the amount of the previously deducted inventory. As an offsetting adjustment to cost of goods sold it is determined, for the same reason, that the partnership is entitled to deduct the cost, $10,473.26, of merchandise purchased in 1951 but not paid for until 1952, and which was not deducted in its returns for either year. Accordingly, the cost of goods sold as reported in the 1952 return has been disallowed to the extent of the net amount of these adjustments, or $52,205.56.

The respondent determined that the resulting adjusted

income of the partnership was taxable in proper proportions to the petitioners.

On June 10, 1955, the petitioners paid the deficiencies so determined by the respondent in the alternative for the year 1951. The petitions filed with this Court relate only to the years 1950 and 1952.

OPINION.

Prior to the calendar year 1952 the partnership, of which the individual petitioners were partners, kept its books and filed its income tax returns upon the cash receipts and disbursements method of accounting. For the year 1952 it changed its method of accounting to an accrual method and filed its return for that year in accordance with that method. It did not request the permission of the respondent to such a change of method, but the respondent accepted this method for 1952. The parties have stipulated that this was the proper method for that year.

However, the respondent determined that as a result of the change of accounting method certain adjustments were necessary. These consisted of including in income for the year 1952 the amounts collected on accounts receivable on hand at the beginning of 1952 which represented sales in the prior year but which had not been included in income for such prior year, and the elimination, from the computation of cost of goods sold in 1952, of the 1952 opening inventory, to the extent such inventory had been paid for prior to 1952 and had been deducted in computing income for the prior year. The net effect of these adjustments was the determination of deficiencies by the respondent against the petitioners for

the year 1952. The respondent also determined, in the alternative, that the partnership income for the year 1950 should be computed upon an accrual method, with similar adjustments to those above described in 1952. He accordingly determined deficiencies against the petitioners for the year 1950. This action he concedes is inconsistent with his determination for 1952, but that it was done only in the alternative and merely for the purpose of protecting the revenue.

The petitioners contest the adjustments made by the respondent for both of the years 1950 and 1952. They contend that in earlier years, not later than 1948, the only method of accounting and reporting which could have correctly reflected income would have been an accrual method, and that under the decided cases the respondent is not permitted to make adjustments either in 1950 or 1952 to reflect as income items which properly should have been treated as income in prior years.

Those sections of the Internal Revenue Code of 1939 which bear upon the subject are set forth in the margin.[1] Section 41 provides that the net income shall be computed in accordance with the method of accounting regularly employed

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[1] SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period • • • in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if • • • the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. • • •

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) General Rule.—The amount of all items of gross income shall be included in the gross income for the taxable year in which

(continued)

in keeping the books of the taxpayer. Thus, in all years up to and including the year 1951 the statute, on its face, required the partnership to report its income on the cash basis. But, say the petitioners, this is premised upon the assumption that the method of accounting employed clearly reflected income, and that the cash method employed by the partnership did not do so. They contend that any distinction made in any of the earlier cases based upon the method of accounting which was *actually* employed in prior years is no longer a factor in view of such court decisions as *David W. Hughes*, 22 T.C. 1; *Welp* v. *United States* (C.A. 8), 201 F. 2d 128; *Caldwell* v. *Commissioner* (C.A. 2), 202 F. 2d 112, affirming a Memorandum Opinion of this Court; and *Commissioner* v. *Dwyer* (C.A. 2), 203 F. 2d 522, affirming a Memorandum Opinion of this Court.

Footnote 1 (continued)

received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. • • •

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits • • • provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. • • •

SEC. 22. GROSS INCOME.

• • • • •

(c) Inventories.—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

We have carefully examined the cases cited by the parties. There has been much confusion upon the subject and while statements made in some of the cases might seem to support the petitioners' contention, a close analysis of the facts and circumstances in each case discloses that none of the cases involved a situation comparable to that presented here. Here the partnership started out with a purely commission business upon the cash method. Thereafter it did commence selling merchandise, but whether and when this portion of its business became substantial enough to require the use of inventories and a change to an accrual method was a matter which we think would permit of some reasonable latitude. It is possible that either the cash method or an accrual method would reasonably reflect its income. The partnership itself did not see fit to change its method of accounting until 1952. Although prior to 1952 it did have inventories of merchandise and kept memorandum records thereof, such were not used in computing its income either on its books or for purposes of its tax returns. The partnership's records and returns were examined by an agent of the respondent for the year 1948 and prior years. The petitioner Stanford Brookshire testified that the agent at that time stated that it would be a good idea for the partnership to go on an accrual basis, but that he did not state that an accrual basis was required, and the returns were accepted on the cash basis. Brookshire stated that the method was not changed at that time because he did not think it was necessary. The respondent, in accepting the returns up through 1951 as being correct, has in effect accepted the cash method, as employed by the partnership, as correctly reflecting income. The respondent did not, and does not now, question the adequacy of that method for years prior to 1952. In 1952 the partnership voluntarily changed its method of accounting and voluntarily filed its return on an accrual method.

In the case of *David W. Hughes,* cited by the petitioners, the situation presented was not analogous to that here involved. There the taxpayer had not maintained in prior years a strict cash receipts and disbursements method of accounting and it did not change its accounting method in the year in question. On the same day that this Court decided the *Hughes* case we also decided the case of *Clement A. Bauman,* 22 T.C. 7, in which we stated in part:

> * * * The taxpayers' position that in the changeover from cash to accrual reporting of income, an accrual method must be used throughout in computing income without any effort to bring into account income of a prior year to prevent it from escaping taxation is amply sustained by *Commissioner* v. *Dwyer,* (C.A. 2, 1953) 203 F. 2d 522, affirming a Memorandum Opinion of this Court, and *Caldwell* v. *Commissioner,* (C.A. 2, 1953) 202 F. 2d 112, affirming a Memorandum Opinion of this Court; also by *Welp* v. *United States,* (C.A. 8, 1953) 201 F. 2d 128. The *Dwyer* decision expressly overruled *Hardy* v. *Commissioner,* 82 F. 2d 249, reversing a Memorandum Opinion of this Court, which is relied on by the respondent here. The basis for these holdings is that the authority of the respondent to require a taxpayer to use an accrual basis of reporting income in cases where his books and records are kept on an accrual basis does not include the authority to add to the income for the year of changeover items which were income of a preceding taxable period. See *David W. Hughes,* 22 T.C. 1; *Commissioner* v. *Schuyler,* 195 F. 2d 85, affirming a Memorandum Opinion of this Court. *It should be remembered that this is not a case where the taxpayers have been keeping their books and records on the cash basis and have sought to change over to an ac-*

crual basis without securing the consent of the Commissioner to make such a change. If it were that kind of a case, the situation might be different. As we have already pointed out, petitioners have been keeping their books and records on an accrual basis. * * * [Emphasis supplied.]

In the circumstances of the instant case, we are unwilling to say that the respondent's insistence upon the adjustments for 1952 is unreasonable or in contravention of the principles developed in the litigated cases, particularly since the result would not be to include in income of one year that of another year barred by the statute of limitations. But in any event we think the petitioners cannot prevail here since they have not shown that prior to 1952 the partnership's method of keeping its books and filing its returns did not correctly reflect its income. The respondent has accepted the prior years' accounting method and the returns as being correct and we think the petitioners have the burden of showing they were not. The petitioners rest their case in this respect principally on provisions of Regulations 111,[2] particularly section

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[2] Sec. 29.22(c)-1. Need of Inventories.—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. * * *

Sec. 29.41-2. Bases of Computation and Changes in Accounting Methods.—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to re-

(continued)

Footnote 2 (continued)

flect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchase and sales will correctly reflect income except an accrual method. • • •

The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa. • • • Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. • • •

Sec. 29.41-3. Methods of Accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his

(continued)

29.22(c)-1 to the effect that inventories are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor, and section 29.41-2 to the effect that in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method.

It is true that the character of the business did change to the extent that a part thereof consisted of buying and selling merchandise, and that as a consequence the partnership did have actual inventories of goods on hand, as set forth in the Findings of Fact. But the language of section 22(c) of the Code appears to clearly contemplate that the use of inventories may or may not be necessary in order clearly to reflect the income of a particular taxpayer. And it has been held that the mere fact that there were inventories does not necessarily mean that the cash receipts and disbursements method did not correctly reflect income. *Theodore H. Beckman*, 8 B.T.A. 830, and *Glenn* v. *Kentucky Color & Chemical Co.* (C.A. 6), 186 F. 2d 975. As pointed out in the latter case, the use of inventories is a feature to be considered but is not controlling. It is true in the instant case that as of the end of the year 1948 there was a marked increase in the inventory as well as a

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Footnote 2 (continued)

true income. He must, therefore, maintain such accounting records as will enable him to do so. • • • Among the essentials are the following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year • • •.

sizable increase in the amount of accounts receivable. The petitioners state that during the years 1945 through 1951 inventories and accounts receivable represented more than two-thirds of the value of the partnership's assets as of each January 1. This is true only if commissions receivable are included. But in any event we do not see that this proves that the cash receipts and disbursements method did not clearly reflect income during those years. The petitioners have not demonstrated on brief or otherwise the extent of any claimed distortion of income by the method employed in those years. Indeed, the petitioner Stanford Brookshire conceded in his testimony that inventory as great as $62,000 was not a tremendously large factor or item as compared with the partnership's total annual sales, stating that most of the sales were made with shipments direct to the customers instead of to the partnership's stock. The internal revenue agent who made an examination of the partnership's accounting methods for the years 1932 through 1951 was called as a witness by the respondent and testified unequivocally that for all years up to and including the year 1951, the income of the partnership was clearly reflected by the cash receipts and disbursements method. This agent is a certified public accountant and the petitioners concede that he is very well qualified. The petitioners did not present any testimony to the contrary. In this state of the record we cannot conclude and hold that the income of the partnership was not correctly reflected by the method employed in years prior to 1952.

In *Advance Truck Co.*, 29 T.C. 666, affd. (C.A. 9) F. 2d , we stated that the statute is designed to see to it that all items of gross income shall be properly accounted for in gross income for some year, and pointed out that under section 42 items of gross income are to be included in gross income of the taxable year in which received by the taxpayers

unless properly to be accounted for as of a different year. And in affirming our decision, the Court of Appeals for the Ninth Circuit held that since the taxpayer had in prior years been on the cash method an income tax status was created with respect to the accounts receivable on a cash-realization basis, requiring that collections be included in income in the year of collection, even though at that time the taxpayer was on an accrual basis. *Goodrich* v. *Commissioner* (C.A. 8), 243 F. 2d 686, reversing 25 T. C. 1235, cited by the petitioners, is not to the contrary. The Court of Appeals there recognized that although accounts receivable at the beginning of the year of change may not be put into income of the year of change, the amounts collected thereon in such year constitute taxable income upon collection.

The accounts receivable with which we are here concerned were not taxable in 1951 under the accounting method employed by the partnership, nor would they be taxable in 1952 under the accrual method since they did not come into existence in that year. However, these items attained a tax status under the cash method and must be considered as items of income in 1952 when collected, under the principle of the *Advance Truck* case. Under the method employed by the partnership in years prior to 1952, all amounts collected were treated as income and all amounts paid out, including the cost of goods, were treated as deductible. Accordingly, we hold that the respondent properly included in income in 1952 amounts collected in 1952 on accounts receivable on hand at the beginning of that year. The inventory on hand at the beginning of 1952 which was paid for in 1951 also acquired a similar tax status when its cost was deducted in 1951 under the partnership's method of accounting, and we think the partnership is not entitled to in effect deduct such cost again in computing taxable income for 1952. It has not been shown

that the deduction in the prior year was erroneous under the method of accounting then employed. Accordingly, we also approve the respondents disallowance of such inventory in the computation of cost of goods sold for 1952.

The petitioners contend that the fact that they accepted the alternative determination of the respondent for the year 1951 and paid the deficiency determined requires or tends to require a holding here that no adjustments are to be made for the year 1952. We disagree. In the notices of deficiency the respondent made it abundantly clear that his determination for both 1950 and 1951 was merely in the alternative.

We approve the respondent's determination as to the year 1952; consequently there is no deficiency for the year 1950 as determined by the respondent in the alternative.

Decisions will be entered under Rule 50.

DECISION

[Caption Omitted]

Pursuant to the determination of the Court as set forth in its Findings of Fact and Opinion filed March 18, 1959, the respondent herein, on May 4, 1959, filed a recomputation for entry of decision, and the petitioners herein having noted their acquiescence in the respondent's recomputation, it is

ORDERED and DECIDED: That there is no deficiency and no overpayment in income tax for the taxable year 1950, and that there is a deficiency in income tax for the taxable year 1952 in the amount of $28,109.88.

Entered May 8, 1959

(Signed) CRAIG S. ATKINS
Judge.

DECISION

[Caption Omitted]

Pursuant to the determination of the Court as set forth in its Findings of Fact and Opinion filed March 18, 1959, the respondent herein, on May 4, 1959, filed a recomputation for entry of decision, and the petitioners herein having noted their acquiescence in the respondent's recomputation, it is

ORDERED and DECIDED: That there is no deficiency and no overpayment in income tax for the taxable year 1950, and that there is a deficiency in income tax for the taxable year 1952 in the amount of $27,785.56.

Entered May 8, 1959

(Signed) CRAIG S. ATKINS
Judge.

APPENDIX C

Research Institute

TAX RECOMMENDATIONS

Business — Personal — Family

February 13, 1960

NEW TAX BREAK FOR MANY BUSINESSES

BACKGROUND: It's not widely recognized that a company which sells merchandise can often save a substantial amount of taxes by using the cash basis, *because no tax is due on its receivables and inventory.* In a going business, this represents an addition to the capital by way of a semi-permanent tax deferment.

The trouble, though, has been the Treasury Regulations, which limit the cash basis method of reporting to *cases where income is determined without reference to inventories.*

The tax Regulations have consistently required a business to use the *accrual* method of reporting if it must use inventories in order to determine its income. And the Regs also say that the use of inventories is required where the production, purchase and sale of merchandise is an income producing factor.

In effect, therefore, a great many businesses have not felt free to seek the tax savings possible under cash basis reporting.

But some cracks have been made in the Treasury's position over recent years . . .

Despite the clear and unequivocal Regulations, the Sixth Circuit Court held in '51 that the use of inventories and the use of the accrual basis were *not* mandatory if income could be clearly reflected without them.

Illustration: Where a cash basis taxpayer used inventories in arriving at taxable income, but didn't accrue items amounting to 7% of gross sales, 1.8% of cost of goods sold, and 2.1% of other costs, the cash basis was held clearly to reflect income.

Still, there was danger for taxpayers because other courts disagreed. But now an important new decision seems to open the door much wider to taxpayers who would benefit by cash basis reporting . . .

NEW FAVORABLE RULING: In the case described below, a court has permitted the cash basis to be used where the business had a substantial dollar amount of inventories and receivables . . .

It happens that in the way this case came up, the Treasury had to argue that *the cash basis was correct* on the following facts — so that in winning the decision, it has provided the basis for the advantages described above . . .

ENGINEERING SALES CO. began as a straight commission operation, using the cash basis. Thereafter it began to sell a small amount of merchandise but still used the cash basis. In '45, inventory and receivables totaled $18,000. By Jan. 1, '52 these had grown to $95,000 and the gross profit from sales was more than double the commissions. Gross sales of goods were then $408,000, gross profit $86,000.

Without asking permission, the company switched to the accrual basis and claimed that the Jan. 1, '52 balance of inventory was deductible in '52, and that the receivables as of the same date weren't taxable. It claimed that this change was forced by the Regulations because its cash basis was wrong.

Both the Tax Court and Fourth Circuit followed the earlier Sixth Circuit view that the Regs aren't mandatory on this point. The rule that emerges is that *even if* there are inventories, the cash basis may nevertheless correctly reflect income.

The Court said:

". . . Some reasonable flexibility must be permitted in determining when the purchase and sale of merchandise becomes such an income producing factor as to require the use of inventories and a change to an accrual method, in order to reflect clearly the income of a taxpayer." (Refer to the case of Stanford R. Brookshire et ux. v. Commissioner, Fourth Circuit Court of Appeals, 1/4/60.)

Under the *Brookshire* doctrine, many normal businesses could avoid using the accrual basis. Inventory and receivables may increase at a fairly modest rate, eventually reaching a substantial sum. But the yearly discrepancy between cash and accrual basis may be relatively small. And the courts seem to look at this modest *yearly* difference, rather than the *total*, in deciding whether the cash basis clearly reflects income.

Observation: The *Brookshire* victory may prove costly to the Treasury. By claiming that a mercantile business need not necessarily use inventories and the accrual basis, it has opened the door for taxpayers who can save taxes by staying with the cash basis. While *Brookshire* involved a pre-'54 year, *the same general principles apply today with respect to use of cash and accrual methods.*

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No. 897

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In the Supreme Court of the United States

OCTOBER TERM, 1959

STANFORD R. BROOKSHIRE and wife, EDITH M. BROOKSHIRE, and VORIS C. BROOKSHIRE and wife, HELEN M. BROOKSHIRE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

J. LEE RANKIN,
Solicitor General,

CHARLES K. RICE,
Assistant Attorney General,

HARRY BAUM,
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Department of Justice,
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In the Supreme Court of the United States

OCTOBER TERM, 1959

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STANFORD R. BROOKSHIRE and wife, EDITH M. BROOKSHIRE, and VORIS G. BROOKSHIRE and wife, HELEN M. BROOKSHIRE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

For years prior to 1952, a partnership of which the taxpayers were members kept its books and reported its income on the cash method of accounting, and the returns were accepted by the Commissioner as clearly reflecting the partnership's income. At the beginning of that year, the partnership had substantial accounts receivable from sales made in 1951,

which it properly failed to report as income for 1951 because the amounts had not yet been collected. It also had goods on hand, the cost of which had been paid for and properly deducted in prior years. In 1952 (the taxable year), without seeking or obtaining the Commissioner's permission, the partnership changed from the cash to the accrual method of accounting, with the results (1) that the accounts receivable from sales made in 1951 and collected in 1952 were not reported as income in either year, and (2) that the cost of goods paid for and already deducted in prior years was again deducted in 1952. The Commissioner accepted the 1952 return on the accrual basis, but in order correctly to reflect the partnership's net income, he included the unreported sales proceeds in gross income and disallowed the repeated deduction. The Commissioner's action resulted in the deficiencies in controversy.

The court below, in a carefully reasoned opinion affirming the Tax Court, held that the taxpayer-partners could not escape tax on part of their business income by changing the partnership's method of reporting its income from the cash to the accrual basis, and it accordingly sustained the Commissioner's adjustments. Its decision is in complete accord with the applicable statutory provisions (Sections 41, 42 and 43 of the Internal Revenue Code of 1939 (26 U.S.C., 1952 ed., 41, 42 and 43)), the implementing Treasury Regulations (Sections 39.41-1, 39.41-2 and 39.41-3 of Regulations 118), and the relevant decisions (*Advance Truck Co.* v. *Commis-*

sioner, 262 F.2d 388 (C.A. 9th); *Goodrich* v. *Commissioner*, 243 F.2d 686 (C.A. 8th)).[1]

The cases upon which the taxpayers rely (Pet. 12-19) do not present a conflict. As pointed out in the opinions below (Pet. App. A 9-10; Pet. App. B 11), they are distinguishable on one or both of two grounds: either because the change in accounting method was not made voluntarily by the taxpayer but was required by the Commissioner (*e.g.*, *Welp* v. *United States*, 201 F. 2d 128 (C.A. 8th)); or because the taxpayer had mistakenly failed to report income (or had mistakenly taken a deduction) in a year prior to the year of change-over (*e.g.*, *Commissioner* v. *Dwyer*, 203 F.2d 522 (C.A. 2d)). No such situation is here presented. In the instant case, the change in accounting method was made voluntarily,

[1] The decision is also in harmony with Section 481(a) of the Internal Revenue Code of 1954, as amended by Section 29 (a) (1) of the Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606 (26 U.S.C. 481(a)), which specifically requires a taxpayer who changes his method of accounting to make adjustments "in order to prevent amounts from being duplicated or omitted". See also, H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 50, A164 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4075-4076, 4303)), pointing out that such adjustments are necessary to prevent "ommissions or doubling ups" of items of income or deduction, and that "under the present law" they are made "whenever the taxpayer requests permission to change his method of accounting". A *fortiori*, such adjustments are required where (as here) the taxpayer voluntarily changes his method of accounting without requesting the Commissioner's consent. See Section 39.41-2 of Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939; *Bauman* v. *Commissioner*, 22 T.C. 7.

without securing the Commissioner's consent. And, as both courts below found (Pet. App. A 9; Pet. App. B 11), the partnership correctly (not mistakenly) used and applied the cash method for years prior to 1952. In the words of the court below (Pet. App. A 11): "The adjustments required by the Commissioner were made to prevent duplications or omissions resulting from the voluntary changeover. They were not made to correct errors of past years."

The decision below is clearly correct. There is no conflict, nor any other occasion for further review. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

HARRY BAUM,
CAROLYN R. JUST,
Attorneys.

JUNE, 1960.

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